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**COORDINATED ISSUE
MAQUILADORA INDUSTRY
DEBT/EQUITY SWAPS**

BACKGROUND ON DEBT/EQUITY SWAPS

Due to the depressed economic conditions in countries in Latin America and elsewhere and the problems these countries have encountered in servicing their world-wide debt, the governments of these countries have been willing to enter into so-called debt/equity swaps with foreign businesses. Because of their lack of creditworthiness, the U.S. dollar denominated debt issued by these countries can be purchased on the international market at substantial discounts from face value. For instance, a market purchase price might be 65 percent of face value; i.e., a market discount of 35 percent. In order to retire that debt without the use of hard currency and in order to encourage foreign investment, the governments of these countries will repurchase (retire) this U.S. dollar denominated debt with local currency equal to 70 to 100 percent of face value. The funds used to repurchase the debt must, however, be invested in the countries, typically through corporations organized under their laws.

Thus in the above example, a U.S. parent corporation is able to obtain foreign debt on the international market for a cost of 65 percent of face value plus a 1 to 2 percent commission to the investment banker (or other broker) and exchange it for restricted currency nominally equal to 70 to 100 percent of the face value. Such currency must be invested in the foreign country, as provided in the agreement.

This issue involves several countries including, but not limited to, Mexico, Brazil, Ecuador, Chile, and Argentina. We have found that, while the swap transactions are typically the same, some taxpayers structure the swap in such a way as to disguise or hide the gain. To present the proper method for reporting a debt/equity swap gain in an effective manner, the following discussion will be based on Mexico's swap program.

ISSUE

Is a taxpayer required to recognize gain from a debt/equity swap transaction, and if so, what is the amount of that gain?

FACTS

Taxpayer invested in a plant in Mexico through a Mexican subsidiary. Taxpayer made this investment by taking advantage of Mexico's Debt/Equity Swap Program. Taxpayer purchased Mexican Government U.S. dollar-denominated debt from a bank for \$3 million -- a 50% discount from its face value of \$6 million. Taxpayer then surrendered the debt to the Secretaria de Hacienda y Credito Publico (SHCP) (the agency of the Mexican Government dealing with money supply, collection of taxes, and issuance and management of foreign and domestic debt). In exchange, the SHCP paid taxpayer's Mexican subsidiary an amount of pesos equal to \$5,220,000 at the free market rate. This amount was calculated by multiplying the face amount of the canceled debt by the current pesos per dollar free market exchange rate less a 13% discount determined in advance by the governmental agencies which negotiated and approved the swap. The Mexican corporation issued qualified capital stock, with a par value equal to the peso proceeds, to the Mexican Government which gave it to the taxpayer. Certain restrictions applied to the pesos received by the Mexican subsidiary and to the capital stock. The swap proceeds had to be invested in Mexico. The stock could not be sold to other Mexican persons.

Taxpayer paid \$50,000 to a bank to arrange the debt/equity swap transaction.

Taxpayer did not report a gain or loss from the debt/equity swap transaction.

LAW

I.R.C. § 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in I.R.C. § 1011 for determining gain.

I.R.C. § 1011 provides that the adjusted basis for determining gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis as determined under I.R.C. § 1012. I.R.C. § 1012 provides that the basis of property shall be the cost of such property.

I.R.C. § 118 and the regulations thereunder provide that a contribution to the capital of a corporation by a non-shareholder is tax-free so long as the payment is not made in consideration for goods or services.

The Service has set forth its position in Rev. Rul. 87-124, 1987-2 C.B. 205, which states that debt/equity swaps result in taxable gain.

In G.M. Trading Corp. v. Comm'r, 103 T.C. 59 (1994), which involved a typical debt/equity swap, the Tax Court found that the restrictions imposed on the pesos and on the stock received by the taxpayer were not significant and did not affect their value. Consequently, the court held that the taxpayer had taxable gain under section 1001 on the exchange of the debt for the pesos measured by the difference between the value of the pesos received by the taxpayer, as determined according to the free market exchange rate, and taxpayer's basis in the debt.

The Tax Court has granted G.M. Trading Corporation's motion for reconsideration. The Service believes that the current opinion will stand and intends to support the conclusions reached therein.

DISCUSSION

a) Issues decided by G.M. Trading

It is clear that a debt/equity swap is a taxable exchange under section 1001. The real issue is whether the value of the pesos received by the taxpayer is greater than taxpayer's basis in the U.S. dollar denominated debt.

The value of the pesos must be determined based on what the taxpayer could obtain for them on the free market. As the Tax Court in G.M. Trading found, the pesos themselves had to be used for a specific purpose and could not be sold, but the stock in the Mexican subsidiary could be sold to non-Mexican entities -- the real market for Maquiladora plants -- and to U.S. subsidiaries of Mexican entities. In effect, therefore, the pesos were freely transferable.

The Tax Court also rejected the argument that gains from a debt/equity swap transaction are not taxable under section 118. The court found that the Mexican Government had received specific tangible benefits and consequently the taxpayer could not benefit from the non-recognition provision of section 118. The benefit in question was the retirement of dollar-denominated debt in exchange for pesos that will be spent in Mexico.

b) Issues not covered by G.M. Trading

G.M. Trading concluded that the taxpayer in that case had to recognize gains by finding that the restrictions imposed on the pesos obtained through the transaction were not significant and by holding that section 118 is not applicable in this context. Taxpayer, however, may present additional arguments, which are considered below.

Taxpayer may argue that the step transaction doctrine should apply, and that the exchange was nothing more than a purchase of pesos. This characterization, however, must fail. It was taxpayer that purchased the debt from a third party. That step cannot be ignored. Furthermore, even if the step-transaction doctrine were to apply and taxpayer were deemed to have purchased pesos that it contributed to its Mexican subsidiary, the taxpayer would have to recognize gain under section 367(a). The gain would be measured by the difference between the taxpayer's basis in the pesos and the fair market value of the pesos, which, as determined by the Tax Court in G.M. Trading, was equal the translation of the pesos at the free-market rate.

Moreover, it cannot be argued that taxpayer contributed \$3 million in cash to its Mexican subsidiary which then entered into the swap agreement with the Mexican Government. As the tax Court in G.M. Trading found, the taxpayer, as purchaser of the debt, was a real party to the transaction. In any event, had the court found otherwise, the subsidiary's gains would have resulted in Subpart F income to the taxpayer. I.R.C. § 951.

Taxpayer may also rely on cases such as U.S. v. Davis, 370 U.S. 65 (1962) or Philadelphia Park Amusement Co. v. U.S., 126 F.Supp. 184 (Ct. Cl. 1954) to argue that the value of the pesos did not exceed the purchase price of the Mexican Government debt. The principle enunciated in these cases is that items that are exchanged at arm's length must be of equal value. The argument is that the value of the debt is known and must be equal to the value of the pesos obtained by the taxpayer. The debt/equity swap, however, was more than just a swap of debt for pesos. Taxpayer also gave up its right to be paid in dollars. Put another way, the Mexican Government was willing to pay more pesos to avoid spending its hard currency reserves. In addition, the cases cited above apply when one of the items does not have a readily ascertainable value. Here, the value of the pesos received by the taxpayer was readily ascertainable. Because the restrictions imposed on the pesos or on the stock of the Mexican subsidiary were not significant (as the Tax Court found in G.M. Trading) the value of the pesos was established by the free-market exchange rate.

RECOMMENDED POSITION

The analysis set forth in G.M. Trading is applicable to the debt/equity swap entered into by the taxpayer. The taxpayer has thus realized a taxable gain under I.R.C. 1001(a) based on the difference between the FMV of the foreign currency over the adjusted basis in the debt. The FMV of the foreign currency is equal to the value of the pesos converted into dollars at the free market rate because the restrictions imposed on the currency or on the stock received by the taxpayer were not significant.

The gain is computed as follows:

FMV received for obligation		\$5,220,000
Purchase price of obligation	\$3,000,000	
Plus other capitalized acquisition costs	50,000	
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Less adjusted basis		<u>3,050,000</u>
Recognizable gain		\$2,170,000
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